89-393

No.___

IN THE

SUPREME COURT OF THE UNITED STATES

October Term, 1989

HARRY P. BEGIER, JR., Trustee,

Petitioner

v.

UNITED STATES OF AMERICA
INTERNAL REVENUE SERVICE,

Respondents

On Petition for Writ of Certiorari
to the United States Court of Appeals
For the Third Circuit

PETITION FOR WRIT OF CERTIORARI

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QUESTION PRESENTED FOR REVIEW

Whether Congress, in enacting the Bankruptcy Code in 1978, intended the mere fact of payment of funds from a bank account which may be covered by a statutory trust be sufficient to exclude the funds from the property of the estate that is subject to avoidance as preferential transfers under Section 547 of the Bankruptcy Code?

LIST OF PARTIES TO THIS PROCEEDING

Your Petitioner in the instant proceeding is Harry P. Begier, Jr., the duly appointed Chapter 11 Bankruptcy Trustee in the Bankruptcy matter of American International Airways, Inc.[1] which proceeding was originally commenced in the United States Bankruptcy Court for the Eastern District of Pennsylvania under Case Number: 84-02379K on July 19, 1984. The Respondent in this proceeding is the United States of America, Internal Revenue Service.

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1. American International Airways, Inc. is a wholy owned subsidiary of AIA Industries, Inc., both entities of which filed bankruptcy proceedings under Chapter 11 in July of 1984. AIA Industries, Inc. Bankruptcy was filed on July 23, 1984 under Case Number 84-02411.

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OFFICIAL CITATION TO DECISION BELOW

Harry P. Begier, Jr., Trustee v. United States of America, Internal Revenue Service, Appellant, 878 F.2d 762 (3rd Cir. June 30, 1989, *as amended* July 13, 1989, *rehearing denied* July 28, 1989), 58 U.S.L.W. 2032, 89-2 U.S.T.C. Page 9416.

STATEMENT OF JURISDICTION

Your Petitioner appeals from the Opinion and Order of the United States Court of Appeals for the Third Circuit filed on June 30, 1989 and as amended on July 13, 1989. A Petition for Rehearing pursuant to Federal Rule of Appellate Procedure 40(a) and Suggestion for Rehearing en banc was denied by the Third Circuit by Order dated July 28, 1989.

Original jurisdiction for the proceeding in the Bankruptcy Court was founded on 28 U.S.C. Section 1334(b) and 28 U.S.C. Section 157(b)(2)(F). Appellate review by the District Court was based on 28 U.S.C. Section 158(a) and by the United States Court of Appeals for the Third Circuit pursuant to 28 U.S.C. Section 158(d) and Section 1291.

This Petition for a writ of certiorari is brought pursuant to 28 U.S.C. Section 1254(1).

STATUTES AT ISSUE

Section 547 **PREFERENCES**

* * *

(b) except as provided in Subsection (c) of this Section, the Trustee may avoid any transfer of property of the Debtor–

(1) to or for the benefit of a creditor;

(2) for or on account of an antecedent debt owed by the Debtor before such transfer was made;

(3) made while the Debtor was insolvent;

(4) made–

(a) on or within ninety (90) days before the date of filing the Petition; or

(b) between ninety days and one year before the date of filing of the Petition, if such creditor at the time of such transfer–

(i) was an insider; and

(ii) had reasonable cause to believe the Debtor was insolvent at the time of such transfer; and

(5) that enables such creditor to receive more than such creditor would receive if–

(a) the case were a case under Chapter 7 of this title;

(b) the transfer had not been made; and

(c) such creditor received payment of such debt to the extent provided by the provisions of this title.

11 U.S.C. Section 547(b)(1982)[1]

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1. As noted by the Court of Court of Appeals in their decision in the instant case, 11 U.S.C. Section 547(b) was amended in 1984, although the earlier version is applicable to this case. Public Law No. 98-353, Title III, Sections 310, 462 July 10, 1984, 98 Stat. 355, 378 was made applicable only to cases commenced ninety days following enactment. Since this case was filed on July 19, 1984, the 1982 provisions of the Bankruptcy Code apply. *Begier v. United States*, 872 F.2d 762, ____ (3rd. Cir. 1989) (Appearing at Page 6 of Official Opinion.)

Section 541 **PROPERTY OF THE ESTATE**

(a) The commencement of a case under Section 301, 302, or 303 of this title creates an estate. Such estate is comprised of all the following property, wherever located:

(1) Except as provided in subsections (b) and (c)(2) of this section, all legal or equitable interests of the debtor in property as of the commencement of the case.

* * *

(7) Any interest in property that the estate acquires after the commencement of the case.

* * *

(d) Property in which the debtor holds, as of the commencement of the case, only legal title and not an equitable interest, such as a mortgage secured by real property, or an interest in such a mortgage, sold by the debtor but as to which the debtor retains legal title to service or supervise the servicing of such mortgage or interest, becomes property of the estate under subsection (a) of this section only to the extent of the debtor's legal title to such property, but not to the extent of any equitable interest in such property that the debtor does not hold.

11 U.S.C. Section 541. (1982)

Section 7501 **LIABILITY FOR TAXES WITHHELD OR COLLECTED.**

(a) General rule.

Whenever any person is required to collect or withhold any internal revenue tax from any other person and to pay over such tax to the United States, the amount of tax so collected or withheld shall be held to be a special fund in trust for the United States. The amount of such fund shall be assessed, collected and paid in the same manner and subject to the same provisions and limitations (including penalties) as are applicable with respect to the taxes from which such fund arose.

26 U.S.C. Section 7501 (1984).

STATEMENT OF CASE

Your Petitioner respectfully requests this Court review a Decision rendered by the United States Court of Appeals for the Third Circuit which reversed a Decision of the United States District Court affirming a Final Order of the United States Bankruptcy Court by The Honorable David A. Scholl, United States Bankruptcy Judge. The Petitioner herein is the Court appointed Chapter 11 Bankruptcy Trustee in the matter of American International Airways, Inc., which proceeding is pending in the United States Bankruptcy Court for the Eastern District of Pennsylvania. The original action was commenced by the Trustee seeking to avoid four transfers made by the Debtor Corporation, hereinafter referred to as "Debtor" to the Internal Revenue Service, hereinafter referred to as "IRS" as preferential transfers pursuant to 11 U.S.C. Section 547(b).

The facts critical to the matter were never in dispute and were largely established before the Bankruptcy Court by a Stipulation of facts submitted by the parties and made a part of the record at trial.[3] Additionally, the Bankruptcy Court made specific findings of fact which were expressly incorporated in the Bankruptcy Court Opinion.[4]

The Debtor was a commercial airline that provided passenger and air cargo service to the Eastern and Central United States. As a regular employer of individual taxpayers, the Debtor was required to withhold and pay on a quarterly basis certain employment taxes, specifically the employee's share of withholding taxes and the employee's share of Federal Insurance Compensation Act taxes. The Debtor was also required to pay the employer's share of the FICA assessment. Additionally, as an airline carrier, the Debtor was subject to certain Federal Excise taxes collected from airline passengers. These taxes were all required to be paid by the Debtor to the IRS.

By the first quarter of 1984, the Debtor had become delinquent in the filing and the payment of its Social Security,

3. A copy of the Stipulation is attached and included in the Appendix to this Petition.

4. *Begier v. IRS*, 83 B.R., 324, 326-7 (Bkrtcy. E.D. Pa. 1987).

Federal Income and Excise taxes in an amount which approximated One Million Five Hundred Thousand Dollars ($1,500,000). As a direct result of the poor filing and payment history of the Debtor, the IRS issued a notice pursuant to 26 U.S.C. Section 7512 requiring the debtor to file its return on a monthly basis. The Appellant further required the Debtor to establish a special account for future deposit of all tax obligations. These notices were delivered by mail on February 22, 1984 and personally served upon a principal of the Debtor on March 1, 1984.

In response to the notices, the Debtor established a specially designated tax account on March 6, 1984 and deposited sums therein on March 22, March 30, April 13, and April 17, 1984 which payments totalled Six Hundred and Ninety Five Thousand and Fifty One Dollars and Forty Two Cents ($695,051.42). From this designated account, the Debtor on April 30, 1984 drew Six Hundred and Ninety Five Thousand Dollars ($695,000) and transferred these sums directly to the IRS. This payment was accompanied by a check from the Debtor's general operating account in the amount of Seven Hundred and Forty Six Thousand, Four Hundred and Thirty Four Dollars ($746,434). These payments were transmitted with a letter from the Debtor Corporation specifically directing the application of the monies to varying tax obligations for specific periods. The application of these monies as directed by the Debtor was subsequently confirmed by the Revenue Officer of the Internal Revenue Service responsible for the delinquent entity.

Additional transfers were paid out of the Debtor's general operating account by check dated June 22, 1984 in the amount of Two Hundred Thousand Dollars ($200,000) and then subsequently by check dated June 24, 1984 in the amount of Eleven Thousand, Six Hundred and Thirty Six Dollars and thirty five cents ($11,636.35). On each occasion the delivery of the payments was accompanied with a specific direction from the Debtor designating the application of the payment to specific taxes due.

The Trustee, during the administration of the bankruptcy proceeding, instituted this action against the Internal Revenue Service seeking to avoid the three transfers from the Debtor's operating account as preferential payments made by the Debtor. Following a trial on the merits and in full consideration of the Stipulation of the parties submitted previously thereto, the Bankruptcy Court found the Trustee entitled to avoid Seven Hundred Thousand, Four Hundred and Ten Dollars ($700,410) as preferential transfers made by the Debtor to the IRS. *Begier v. United States Internal Revenue Service,* 83 B.R. 324, 333 (Bkrtcy. E.D. Pa. 1988).

Based on the facts as stipulated, the IRS acknowledged before the Bankruptcy Court that the Trustee had established the requisite elements for avoidability under 547(b). The IRS unsuccessfully argued, however, that the three transfers at issue should be excepted from avoidance pursuant to a certain affirmative defense included in the Statute under Section 547(c)(2). The Bankruptcy Court ruled that the IRS failed to carry its affirmative burden in establishing each element of the defense and granted judgment in favor of the Trustee. *Id.* at 328, 333. The Bankruptcy Court decision was affirmed by the District Court in an unreported decision. *Begier v. United States Internal Revenue Service,* No. 88-3529 (D. E.D. Pa. August 15, 1988) (Donald W. VanArtsdalen, J.).

On Appeal to the Third Circuit Court of Appeals, the IRS relinquished its argument regarding the affirmative defense and instead pursued an issue which originally was summarily disposed in the Bankruptcy Court. The IRS argued before the Court of Appeals, by operation of law, a statutory trust imposed under the Internal Revenue Code in Section 7501 should take precedent over the Bankruptcy Code whereby any payment for withholding taxes to the government, regardless of the source, removed the property from being considered part of the Debtor's estate thereby precluding avoidability.[5]

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5. Section 547(b) of the Bankruptcy Code requires that a Trustee may only avoid transfers which are the property of the estate. 11 U.S.C. Section 547(b)(1982).

The Third Circuit analyzed this issue the same as have several Courts who have previously addressed the point. The Court found the terms included in the Statute to be lacking clear directive therefore looked to the legislative history for further guidance. The majority Opinion of The Third Circuit adopted the rationale set forth in the dissenting Opinion by The Honorable Ruth Ginsburg in *Drabkin v. District of Columbia* 824 F. 2d 1102 (D.C. Cir. 1987). The Court below concluded that certain wording in the legislative history mandated special treatment for withholding taxes. While the Court acknowledged that the Internal Revenue Service would not be able to sidestep the Trustee's power to avoid non-trust fund payments such as corporate income taxes, federal unemployment taxes or the employer's share of FICA taxes, it found the ability of the Debtor to make a pre-petition payment on account of withholding taxes, regardless of the source of the funds used to make the payment, impressed with trust characteristics removing the property from the Debtor's estate.

The Third Circuit thereon directed the instant case be remanded to the District Court for findings consistent with the Court's ruling. Upon the entry of the Order, your Petitioner promptly filed a Petition for Rehearing pursuant to Federal Rule of Appellate Procedure 40(a) and a Suggestion for Rehearing en Banc pursuant to Federal Rule of Appellate Procedure 35(a). Both the Petition for Rehearing and Rehearing en Banc were denied by the Court by Order dated July 28, 1989. This petition follows.

ARGUMENT FOR ALLOWANCE OF WRIT

A. The Decision Of The Court Of Appeals For The Third Circuit Creates A Direct Conflict Between Circuits.

It is respectfully presented that a writ of certiorari should be granted by Your Honorable Court in this proceeding. The majority decision of the Third Circuit Court of Appeals creates a direct conflict with an earlier decision of the United States Court of Appeals for the District of Columbia Circuit in the case *Drabkin v. District of Columbia, supra.* The conflict is so direct

that the majority opinion of the Third Circuit expressly adopts the position taken by the dissenting Opinion of the Court of Appeals for the District of Columbia. Judge Hutchinson in the case at bar expressly adopts as its Dissenting Opinion the majority Opinion taken in the same *Drabkin* case.

It has been well established in this Court that Certiorari should be granted where there is a clash of opinions between Courts of Appeals preventing a uniform course of decision made on the same question. *Universal Camera Corp. v. NLRB,* 340 U.S. 474, 71 S. Ct. 456, 95 L. Ed. 456 (1951); *Rice v. Sioux City Memorial Park Cemetery Co., Inc.,* 349 U.S. 70, 75 S. Ct. 614, 99 L. Ed. 897 (1955); *Goldlawr, Inc. v. Heiman,* 369 U.S. 463, 82 S. Ct. 913, 8 L. Ed. 2d 39 (1962). The rationale in support of unified findings by the Courts of Appeals is to avoid divergent conclusions throughout the lower Federal Courts. *Id.* This point is self-evident by the several decisions which have emerged from various Bankruptcy Courts attempting to address the exact issue which is in dispute in this case.[6]

The conflict on the issue is further magnified when considering that of the six judges from the two Courts of Appeals who have considered and ruled upon the issue, three judges have interpreted the legislative history behind the Bankruptcy Code in one way while three others have interpreted the same language exactly opposite. This undoubtedly leaves profound confusion for future interpretation on this issue by any Federal Court. It is critical for this Court to provide uniform direction to the lower Federal Courts.

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6. Compare *Drabkin v. District of Columbia, supra; United States v. Daniel,* 79 B.R. 22 (D.Nev. 1987); *In re Olympic Foundry Co.,* 63 B.R. 324 (Bkrtcy. W.D. Wash. 1986) *rev'd on other grounds,* 71 B.R. 216 (9th Cir. 1987); *Schwartz v. Comm. of Pa.,* 75 B.R. 676 (Bkrtcy. E.D. Pa 1987) *remanded for clarification, slip. opinion* No. 87-4934 (E.D. Pa July 12, 1988); *with In re Rodriquez,* 50 B.R. 576 (Bkrtcy. E.D.N.Y. 1985); *In re Razorback Ready-Mix Concrete Co.,* 45 B.R. 917 (Bkrtcy E.D.Ark. 1984).

B. The Theory Supporting The Majority Opinion Of The Third Circuit Is Opposite Prior Rulings Of This Court.

While this Court has never had the opportunity to address whether a Trustee in Bankruptcy may under Section 547(b) of the Bankruptcy Code avoid pre-petition payments to the Internal Revenue Service on account of federal withholding taxes, the court has had an opportunity to analyze portions of the issue in related circumstances. This Court has on no fewer than three occasions examined whether the imposition of a trust pursuant to Section 7501 of the Internal Revenue Code may remove property from a bankruptcy estate. In each case the court found the imposition of the trust may not be used to remove the property from the debtor. The underlying rationale in these earlier cases should be applied to the case at bar.

In *United States v. Randall,* a case decided under the former Bankruptcy Act, this Court ruled that 26 U.S.C. Section 7501(a) could not be used to impress a trust upon funds held by a bankrupt debtor corporation subsequent to the filing of the bankruptcy petition. *United States v. Randall,* 401 U.S. 513, 91 S.Ct. 991 (1971). The Court found the statutory policy of subordinating taxes to the costs and expenses of administration would not be served by creating or enforcing trusts which eat up an estate leaving little or nothing for creditors and court officers whose goods and services create the assets. *Id.,* 401 U.S. at 516, 91 S.Ct. at 994. The Court ruled that the funds then in the possession of the Debtor could not be found as a trust in favor of the Federal government inasmuch as this claim must succumb to an "overriding statement of Federal policy on questions of priorities." *Id.,* 401 U.S. at 415 91 S.Ct. at 993.

A few years following *Randall,* this Court had another occasion to review 26 U.S.C. Section 7501 in the bankruptcy context. In *U.S. v. Slodov,* this Court ruled that a trust under 26 U.S.C. Section 7501 cannot be impressed on after acquired funds. *United States v. Slodov,* 436 U.S. 238, 98 S.Ct. 1778, 56 L.Ed. 2d. 251 (1978). This Court found that "under Section 7501 there must be nexus between the funds collected and the trust created. That construction is consistent with the accepted

principal of trust law requiring tracing of misappropriated trust funds into the trustee's estate in order for an impressed trust to arise". *Slodov, Id.*, 436 U.S. at 256, 98 S.Ct. at 1790 citing to D. Dobbs, *Handbook on the Law of Remedies*, 424-425 (1973). *Randall* and *Slodov* have been cited repeatedly for requiring the IRS to establish a nexus between the funds withheld from employee's paychecks and the monies held by the employer in order to establish the impressed trust. The failure of the taxing authority to trace this connection precludes the imposition of the trust.

In a case decided under the Bankruptcy Reform Act of 1978, this Court has further ruled that property of the estate includes property of the debtor that had been seized by the Internal Revenue Service prior to the filing of the bankruptcy petition. *United States v. Whiting Pools, Inc.*, 462 U.S. 198, 208-9, 103 S.Ct. 2309, 2315, 76 L.Ed. 2d. 515 (1983). The essence of this Court's ruling in *Whiting Pools* recognized that the taxing authority must protect its interest according to the Congressionally established bankruptcy procedures, rather than, in that case, by withholding seized property from a debtor's efforts to reorganize. *Id.*, 462 U.S. at 212, 103 S.Ct. at 2317.

The Third Circuit differentiated the previous rulings by this Court by emphasizing in its Opinion below that those cases decided under the Act involved transactions in which the IRS was seeking to obtain funds from a debtor post-petition. The Third Circuit believed Congress when enacting the 1978 Bankruptcy Code intended the tracing burden only be applied to funds held as of the commencement of the case. This conclusion, however, fails to consider this Court's ruling in *Whiting Pools* which enabled a debtor to recover property which had been seized by the IRS prior to the filing of the petition. While *Whiting Pools* did not turn on the effect of 26 U.S.C. Section 7501, it did express this Court's opinion that the Internal Revenue Service should be treated no differently than any other creditor. To the extent they held a possessory interest, that interest was subjected to the priorities Congress imposed in preserving a bankrupt debtor's property.

The effect of the Third Circuit's Opinion would be to deny the ability of a bankruptcy trustee to avoid as preferential transfers any pre-petition payments made to the Internal Revenue Service on account of withholding taxes despite the time when the payment was made. Such a result was not the contemplation of Congress. The conclusion of the Third Circuit and the Dissenting Opinion in *Drabkin* is erroneous because their ruling is founded on language from the House Report before it was modified by the Floor Managers' Compromise Legislation. If Congress truly intended to impose a restriction on the avoidability by a bankruptcy trustee of all pre-petition payments on account of trust fund taxes, it could have expressly provided for such exemption in the statute.

As emphasized by the majority Opinion in *Drabkin*, the Senate Report originally precluded the avoidability of all tax payments. The subsequent House Amendment modified the statute to its then current state and omitted the absolute preclusion to avoid tax payments. What it allowed, however, is subject to dispute. The confusion caused by what Congress truly intended requires review by this Court to resolve this important legal issue.

CONCLUSION

For the foregoing reasons, Petitioners respectfully request Your Honorable Court to issue a Writ of Certiorari to review the judgment and Opinion of the United States Court of Appeals for the Third Circuit as entered in this matter.

Respectfully submitted,

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APPENDIX

APPENDIX

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UNITED STATES COURT OF APPEALS
FOR THE THIRD CIRCUIT

No. 88-1788

HARRY P. BEGIER, JR., *Trustee*

v.

UNITED STATES OF AMERICA
INTERNAL REVENUE SERVICE,

Appellant

(D.C. Civil No. 88-3529)

SUR PETITION FOR REHEARING

Present: GIBBONS: *Chief Judge,*
HIGGINBOTHAM, SLOVITER, BECKER,
STAPLETON, MANSMANN, GREENBERG, HUTCHINSON,
SCIRICA, COWEN AND NYGAARD, *Circuit Judges*

The petition for rehearing filed by appellee in the above-entitled case having been submitted to the judges who participated in the decision of this Court and to all the other available circuit judges of the circuit in regular active service, and no judge who concurred in the decision having asked for rehearing, and a majority of the circuit judges of the circuit in regular service not having voted for rehearing, the petition for rehearing by the panel and the Court in banc, is denied. Judge Hutchinson would grant rehearing.

BY THE COURT

Circuit Judge

Dated: July 28, 1989

Filed June 30, 1989

UNITED STATES COURT OF APPEALS
FOR THE THIRD CIRCUIT

No. 88-1788

HARRY P. BEGIER, JR., *Trustee*

v.

UNITED STATES OF AMERICA
INTERNAL REVENUE SERVICE,

Appellant

Appeal from the United States District Court
For the Eastern District of Pennsylvania
(D. C. Civil No. 88-3529)

Argued January 31, 1989

Before HUTCHINSON, SCIRICA *and* NYGAARD,
Circuit Judges

(Opinion filed June 30, 1989)

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OPINION OF THE COURT

SCIRICA, *Circuit Judge.*

This case presents the question whether § 547 of the Bankruptcy Code allows a bankruptcy trustee to avoid as preferential transfers, payments of non-segregated funds to the Internal Revenue Service by the debtor during the pre-bankruptcy petition period in satisfaction of the debtor's tax withholding obligations.

The Internal Revenue Service appeals from a judgment of the district court upholding a decision of the bankruptcy court permitting appellee Harry P. Begier, Jr., the trustee in bankruptcy of debtor American International Airways, Inc., to recover pre-petition withholding tax payments from American International's general operating account. The bankruptcy court determined that the payments were transfers of property of the debtor's estate, not transfers of funds held in trust for the IRS under § 7501 of the Internal Revenue Code. For reasons that follow, we hold these payments, transferred to the IRS before American International's bankruptcy petition was filed, to be a special fund in trust for the government under I.R.C. § 7501 and not recoverable as preferential transfers of the debtor's property. Therefore, we will reverse.

The facts in the case are not disputed. Debtor, American International Airways, Inc., was in the airline business. By the spring of 1984, it had become delinquent in remitting social security and income taxes withheld from employee wages, as well as excise taxes collected from airline passengers, to the United States. On March 1, 1984, the IRS notified American International of this delinquency and required it to file monthly (as opposed to quarterly) returns of its wage withholding and excise taxes, and to open a separate bank account to receive these tax deposits in trust for the IRS.[1]

On March 6, 1984, American International opened a bank trust account and made deposits of wage withholding and excise taxes. On April 30, 1984, American International paid the IRS $695,000 from the separate trust account and $734,798 from its general operating bank account. On June 22 and 27, 1984, it made two more payments from the general operating account of $200,000 and $11,636, respectively. Thus, American International made payments to the IRS of $695,000 from the separate trust account and $946,434 from its general operating account, for a total payment of $1,641,434. All payments were allocated by agreement between American International and the IRS to specific social security, income withholding and transportation excise taxes due from January 1984 to April 1984, except for the payment of $11,636 which was allocated to 1982 and 1983 excise taxes.

On July 19, 1984, American International filed a petition in bankruptcy under Chapter 11 of the Bankruptcy Code. For three months thereafter, the debtor attempted to operate the business as a debtor-in-possession, but failed. Consequently, the bankruptcy court appointed a trustee and the case was converted to a liquidation under Chapter 7 of the Bankruptcy Code. The trustee then filed this adversary proceeding to recover the $1,641,434 tax payments as voidable preferences under 11 U.S.C. § 547(b).

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1. In the event of delinquency, the IRS may require collection of the tax and deposit in a separate account. I.R.C. § 7512.

The bankruptcy court did not allow the trustee to recover the transfer of $695,000 from the separate withholding tax account, holding that this was a transfer of funds held in trust, rather than from the debtor's estate. *Begier v. United States Internal Revenue Service*, 83 B.R. 324, 327 (Bankr. E.D. Pa. 1988). This decision has not been appealed. However, the bankruptcy court determined that the trustee could recover as preferential transfers the $946,434 in payments made from the debtor's operating account, less $246,024.[2] In total, the court allowed the trustee to avoid $700,410 out of the $1,641,434 sought. *Id.* at 328. In explaining why it had treated as voidable preferences the transfers from the general operating account, the court reiterated the conclusion it had drawn in previous cases that, "only where a tax trust fund is actually established by the debtor and the taxing authority is able to trace funds segregated by the debtor in a trust account established for the purpose of paying the taxes in question would we conclude that such funds are not property of the debtor's estate." *Id.* at 329 (*citing In re American Airlines, Inc.*, 70 B.R. 102, 105 (Bankr. E.D. Pa. 1987); *In re Rimmer Corp.* 80 B.R. 337, 338-89 (Bankr. E.D. Pa. 1987)). By order dated, August 15, 1988, the district court affirmed the decision of the bankruptcy court. This appeal followed.

II.

As we have noted, we must decide whether §547(b) of the Bankruptcy Code allows a bankruptcy trustee to avoid as preferential transfers, payments of non-segregated funds transferred from the debtor's general operating account to the IRS during the pre-bankruptcy petition period on account of the debtor's tax withholding obligations. Whether withheld taxes paid pre-petition to the IRS from non-segregated funds commingled with other funds of the debtor are avoidable preferences depends on whether the funds are considered to be property of the debtor's estate or held to be in trust for the IRS.

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2. The court denied recovery of the latter amount because either it was not paid on account of antecedent debts or because it was paid in the ordinary course of business.

The IRS argues that withheld taxes, paid pre-petition, are deemed to have been held in trust for the government under §7501 of the Internal Revenue Code. The trustee responds that because the withheld taxes were commingled with the other funds rather than placed in a separate account, they may not be designated as trust funds and may be recovered.

A.

Section 547(b) of the Bankruptcy Code allows the trustee in bankruptcy to recover payments on account of antecedent debts made by the debtor immediately prior to the filing of a bankruptcy petition:

§547. Preferences

* * *

(b) Except as provided in subsection (c) of this section.

the trustee may avoid any transfer of property of the debtor –

(1) to or for the benefit of a creditor;

(2) for or on account of an antecedent debt owed by the debtor before such transfer was made;

(3) made while the debtor was insolvent;

(4) made –

(A) on or within 90 days before the date of the filing of the petition; or

(B) between 90 days and one year before the date of the filing of the petition, if such creditor, at the time of such transfer –

(i) was an insider; and

(ii) had reasonable cause to believe the debtor was insolvent at the time of such transfer; and

(5) that enables such creditor to receive more than such creditor would receive if –

(A) the case were a case under chapter 7 of this title;

(B) the transfer had not been made; and

(C) such creditor received payment of such debt to the extent provided by the provisions of this title.

11 U.S.C. §547(b) (1982).[3] Section 547(c) of the Bankruptcy Code provides a transferee creditor with defenses to a preference action brought by the trustee. 11 U.S.C. §547(c).[4] Thus, to prevail in a preference action, the trustee must prove that a transfer of "property of the debtor" took place and that the transfer met the criteria listed in §547(b). In addition, the trustee must overcome any 547(c) defenses raised by the transferee. Funds held in trust do not constitute "property of the debtor," and therefore are not recoverable as a preference under §547(b). *See* 11 U.S.C. §541(d).[5]

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3. 11 U.S.C. §547(b) was amended in 1984, although the earlier version is applicable to this case, *See* Pub. L. No. 98-353, Title III, §§310, 462, July 10, 1984, 98 Stat. 355, 378.

4. Former §547(c), applicable to this case, provided in pertinent part:

(c) The trustee may not avoid under this section a transfer –

* * *

(2) to the extent that such transfer was –

(A) in payment of a debtor incurred in the ordinary course of business or financial affairs of the debtor and the transferee;

(B) made not later than 45 days after such debt was incurred;

(C) made in the ordinary course of business or financial affairs of the debtor and the transferee;

(D) made according to ordinary business terms . . . .

11 U.S.C. §547 (1982). Section 547(c)(2) was amended in 1984. *See* Pub.L. No. 98-353, Title III, §462, July 10, 1984, 98 Stat. 355, 378. The amendment struck out, *inter alia*, subparagraph (B), which read "made not later than 45 days after such debt was incurred." Pub.L. No. 98-353, §462(c).

5. 11 U.S.C. §541(d) provides:

(d) Property in which the debtor holds, as of the commencement of the case, only legal title and not an equitable interest, such as a mortgage

Here, the IRS does not contest that the trustee meets the criteria listed in Section 547(b); rather, it argues that the payments were not "transfer[s] of property of the debtor" because the payments represent money held in trust for the IRS pursuant to Section 7501, and as such, are simply not subject to Section 547(b). Section 7501(a) provides:

> §7501. Liability for taxes withheld or collected
>
> (a) General rule. — Whenever any person is required to collect or withhold any internal revenue tax from any other person and to pay over such tax to the United States, the amount of tax so collected or withheld shall be held to be a special fund in trust for the United States. The amount of such fund shall be assessed, collected, and paid in the same manner and subject to the same provisions and limitations (including penalties) as are applicable with respect to the taxes from which such fund arose.

I.R.C. §7501.[6] If a person required to collect or withhold any internal revenue tax from any other person under I.R.C. §7501 fails to collect, account for, or pay over such tax, the IRS may require that person to collect the tax and deposit the amount in a separate bank account. I.R.C. §7512. Thus, §7501 itself does not require segregation of withholding taxes, unless the IRS, finding the employer delinquent in paying over the taxes, demands that the funds be placed in a separate account.

B.

Because of the complicated legislative history and statutory authority in this case, we believe it would be helpful to track the development of the status of withholding tax payments in bankruptcy. Prior to the passage of the 1978 Bankruptcy Act, the seminal case addressing the status of withholding taxes in bankruptcy was *United States v. Randall*, 401 U.S. 513 (1973). In *Randall*, the IRS sought to collect withholding taxes in possession of the debtor after the commencement of the case in bankruptcy and which the debtor had failed to segregate into a separate trust account as required by court order. *Id.* at 514. After dissolution of the corporation, the IRS, arguing that I.R.C. §7501 created a statutory trust, requested the bankruptcy court to pay the amount of withheld taxes to the government before the payment of costs and expenses of administration of the estate, *Id.* at 514-15. The Supreme Court upheld the bankruptcy court's refusal to pay over the withheld taxes, finding that the Bankruptcy Act is an overriding statement of federal policy on bankruptcy priorities, and that "the statutory policy of subordinating taxes to costs and expenses of administration would not be served by creating and enforcing trusts which eat up an estate, leaving little or nothing for creditors and court officers whose goods and services created the assets," *Id.* at 516-17.

Several years later, in another pre-1978 Bankruptcy Act case, the Court found that I.R.C. §7501 does not impose a trust for funds acquired post-petition absent tracing of those funds to taxes collected. *Slodov v. United States*. 436 U.S. 238, 256 (1978). In *Slodov*, the corporation had dissipated its funds pre-petition, and was unable to meet its withholding tax obligations. *Id.* at 242. After the corporation filed for bankruptcy, the

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secured by real property, or an interest in such a mortgage, sold by the debtor but as to which the debtor retains legal title to service or supervise the servicing of such mortgage or interest, becomes property of the estate under subsection (a)(1) or (2) of this section only to the extent of the debtor's legal title to such property, but not to the extent of any equitable interest in such property that the debtor does not hold.

6. Congress passed I.R.C. §7501 (originally §607 of the Internal Revenue Code) to provide the IRS with more effective tax collection methods:

> Existing law provides with respect to a number of taxes that the amount of the tax shall be collected or withheld from the person primarily liable by another person, who is required to return and pay to the Government the amount of the taxes so collected or withheld by him. . . . Under existing law the liability of the person collecting and withholding the taxes to pay over the amount is merely a debt, and he can not be treated as a trustee or proceeded against by distraint. Section [606] of the bill as reported impresses the amount of taxes withheld or collected with a trust and makes applicable for the enforcement of the Government's claim the administrative provisions for assessment and collection of taxes.

S. Rep. No. 558, 73d Cong., 2d Sess. 53 (1934).

We note that the air transportation excise taxes and the withheld employee income taxes in this case are taxes that American International was "required to collect or withhold . . . and to pay over to the United States" under §7501(a), and thus both are subject to the disposition of this appeal.

government argued that the Internal Revenue Code imposed a trust on funds acquired post-petition for the payment of the overdue withholding taxes. *Id.* at 254. The *Slodov* Court concluded that to construe §7501 to impose a trust on property acquired post-petition, when no nexus had been established between that property and the taxes "withheld or collected" under I.R.C. §7501, would conflict with the priority rules in bankruptcy. *Id.* at 255-56. We believe it is significant that both *Randall* and *Slodov* addressed whether the IRS could collect withholding taxes held post-petition.

In 1978, Congress enacted a new Bankruptcy Code. In enacting §541 of the 1978 Bankruptcy Code, Congress allowed "reasonable assumptions" in tracing, thus relaxing the strict tracing requirement required by courts applying *Randall*:

> As to withheld taxes, the House amendment deletes the rule in the Senate bill as unnecessary since property of the estate does not include the beneficial interest in property held by the debtor as a trustee. Under the Internal Revenue Code of 1954 (section 7501), the amounts of withheld taxes are held to be a special fund in trust for the United States. Where the Internal Revenue Service can demonstrate that the amounts of taxes withheld are *still in the possession of the debtor at the commencement of the case,* then if a trust is created, those amounts are not property of the estate.
>
> Where it is not possible for the Internal Revenue Service to demonstrate that the amounts of taxes withheld are *still in the possession of the debtor at the commencment of the case*, present law generally includes amounts of withheld taxes as property of the estate. *See, e.g., United States v. Randall*, 401 U.S. 513 (1973), . . . Nonetheless, a serious problem exists where "trust fund taxes" withheld from others are held to be property of the estate where the withheld amounts are commingled with other assets of the debtor. The courts should permit the use of reasonable assumptions under which the Internal Revenue Service, and other tax authorities, can demonstrate that amounts of withheld taxes are still in the possession of the debtor at the commencement of the case. . . .

124 Cong. Rec. 32417 (Sept. 28, 1978) (statement of Representative Edwards); 124 Cong. Rec. 34016-17 (Oct. 5, 1978) (statement of Senator DeConcini) (emphasis added) (some citations omitted). Thus, for withholding taxes held as of the commencement of the case, i.e. *post-petition*, Congress relaxed the strict tracing requirement required by courts applying *Randall* and allowed the use of "reasonable assumptions" to trace funds paid to the IRS on account of withholding tax obligations to taxes actually withheld by the corporation.[7]

The status of withholding tax payments accrued and paid *pre-petition* was also considered and addressed by Congress in the legislative history of the 1978 Bankruptcy Act. Specifically, Congress addressed whether the trustee in bankruptcy could avoid as preferential transfers pre-petition payments of withholding taxes under §547 of the Bankruptcy Code:

> This provision [§547] will not apply to permit the trustee to recover estimated tax payments by a debtor, because no tax is due when the payments are made. Therefore, the tax on account of which the payment is made is not an antecedent debt. A payment of withholding taxes constitutes a payment of money held in trust under Internal Revenue Code §7501(a), and thus will not be a preference because the beneficiary of the trust, the taxing authority, is in a separate class with respect to those taxes, if they have been properly held for payment, as they will have been if the debtor is able to make the payments.

H.R. Rep. No. 595, 95th Cong., 1st Sess, 373 (1977), *reprinted in* 1978 U.S. Code Cong. & Admin. News 5787, 6329.

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7. *But see In re Miller's Auto Supply Co.*, 75 B.R. 676, 680 n.4 (Bankr. E.D. Pa. 1987) (declining to hold that *Randall* has been overruled by 11 U.S.C. §541(d) and stating that *Randall* still has continuing vitality).

C.

Several bankruptcy courts have considered whether this passage from the House Report protects pre-petition withholding tax payments to the IRS from avoidance when the payments were not made from a specific trust fund established for the benefit of the IRS, but rather were made from the debtor's general operating account. *Compare In re Rodiguez*, 50 B.R. 576 (Bankr. E.D.N.Y. 1985) (if debtor is able to make the withholding tax payment pre-petition, taxes paid must be labeled as trust funds and are protected from avoidance) *and In re Razorback Ready-Mix Concrete Co.*, 45 B.R. 917 (Bankr. E.D. Ark. 1984) (same) *with In re Olympic Foundry Co.*, 63 B.R. 324 (Bankr. W.D. Wash. 1986) (trustee may avoid all pre-petition withholding tax payments made pursuant to state law that were not drawn from a separately established tax account), *rev'd on other grounds*, 71 B.R. 216 (Bankr. 9th Cir. 1987) *and In re Miller's Auto Supplies, Inc.*, 75 B.R. 676, 679-81 (Bankr. E.D. Pa. 1987) (following *Olympic*).

In 1988, in a carefully detailed opinion, the question whether pre-petition payments of withholding taxes from the debtor's general operating account constitute avoidable preferential transfers under §547(b) was squarely addressed by the Court of Appeals for the District of Columbia Circuit in *Drabkin v. District of Columbia*, 824 F.2d 1102 (D.C. Cir. 1987). In *Drabkin*, the bankruptcy trustee sought to recover as preferential transfers under §547(b) withholding tax payments made pre-petition to the District of Columbia by the debtor, Auto-Train Corporation.[8] The bankruptcy and district courts found

8. The District of Columbia Code created a statutory trust for withheld employee income taxes: ". . . [a]ny sum or sums withheld in accordance with the provisions of this section shall be deemed to be, and shall be, held in trust by the employer for the District." D.C. Code Ann. §47-1812.8(f)(1)(1980). The *Drabkin* court found that §7501(a) of the Internal Revenue Code "essentially mirrors the [statutory trust] provision on which the District . . . relies." 824 F.2d at 1105.

In the case *sub judice*, we decide only that funds paid to the IRS pre-petition are held to be a special fund in trust under I.R.C. §7501. This section is specifically mentioned in the legislative history of 1978 Bankruptcy Code. We do not address the status of taxes withheld pursuant to state law. *Cf. In re Miller's Auto Supplies, Inc.*, 75 B.R. 676, 680 (Bankr. E.D. Pa. 1978).

that the payments were avoidable transfers under §547(b). Based on its reading of the legislative history of the Bankruptcy Code, the panel, in an opinion written by Judge Douglas Ginsburg, affirmed and held that the mere pre-petition payment of non-segregated funds did not exclude those funds from property of the estate and thus found them subject to recovery as a preference. *Id.* at 1103. Judge Ruth Bader Ginsburg dissented, concluding that the debtor's pre-petition ability to make the tax withholding payments placed the trust beneficiary in a class separate from other creditors and thus removed the payment from the category of preferences voidable by the trustee. *Id.* at 1118 (Ruth B. Ginsburg, J., dissenting).

Because *Drabkin* is so closely analogous to this case, the trustee urges us to follow the *Drabkin* majority, while the IRS argues that the *Drabkin* dissent is compelling. For reasons that follow, we find the *Drabkin* dissent convincing, and generally follow Judge Ruth Bader Ginsburg's analysis.

D.

In her dissenting opinion, Judge Ruth Bader Ginsburg phrased the central issue in the case: "Does section 547 of the Bankruptcy Code . . . empower the bankruptcy trustee to recover funds transferred to tax authorities during the pre-petition period in satisfaction of the debtor's withholding tax obligation?" *Drabkin*, 824 F.2d at 1117 (Ruth B. Ginsburg, J., dissenting) (citation omitted). The dissent resolved this issue based on the language of the House Report that accompanied the House version of the 1978 Bankruptcy Code. As we have previously noted, the House Report states:

> A payment of withholding taxes constitutes a payment of money held in trust under Internal Revenue Code §7501(a), and thus will not be a preference because the beneficiary of the trust, the taxing authority, is in a separate class with respect to those taxes, if they have been properly held for

payment, as they will have been if the debtor is able to make the payments.

1978 U.S. Code & Admin. News at 6329. According to the dissent, the meaning of the Report's final words ". . . if they have properly been held for payment, as they will have been if the debtor is able to make the payments," clearly means that, "if the debtor is able to make the payment, the taxes 'have been properly held for payment,' which places the trust beneficiary in a class separate from other creditors and thus removes this payment from the category of preferences avoidable by the trustee." *Id.* at 1118 (citing *In re Rodriguez*, 50 B.R. 576, 581 (Bankr. E.D.N.Y. 1985); *In re Razorback Ready-Mix Concrete Co.*, 45 B.R. 917, 922 (Bankr. E.D. Ark. 1984)). We agree with this analysis.

While acknowledging that the debate over avoiding pre-petition payments of withheld taxes had centered primarily on this House Report,[9] the *Drabkin* majority discounted the Report's statement concerning the avoidability of pre-petition withholding tax payments under §547(b) because the passage did

9. The IRS has argued that the House Report supports the conclusion that the payment of withheld taxes to the government from a debtor's general operating account serves to identify those payments as funds held in trust, thus insulating them from avoidance by the trustee in a preference action.

As the *Drabkin* majority observed, courts that have considered the House Report have focused on the final words of the passage: ". . . if they have been properly held for payment, as they will have been if the debtor is able to make the payments." *See Drabkin*, 824 F.2d at 1110-12. Two courts faced with the issue found dispositive the Report's language ". . . as they will have been if the debtor is able to make the payments," thereby holding for the taxing authority on the grounds that, if the debtor is able to make the payment, the monies would be labled trust funds and the debtor's duty as trustee regarded as completed. *E.g., In re Rodriguez*, 50 B.R. at 581: *In re Razorback Ready-Mix Concrete Co.*, 45 B.R. at 922. On the other hand, a third court found dispositive the language ". . . if they had properly been held for payment," thereby allowing the trustee to avoid all pre-petition payments of withholding taxes to the state that were not drawn from a separately established fund. *In re Olympic Foundry Co.*, 63 B.R. at 328.

The *Drabkin* majority declined to rely on either the *Rodriguez-Razorback* analysis or the *Olympic Foundry* analysis *See Drabkin*, 824 F2d at 1110-12 (disapproving analysis based on legislative "snippets").

little to clarify what the majority considered the central issue in the case: whether the transfer was of estate property as defined by §541 of the Bankruptcy Code or whether the transfer was of trust funds.[10] According to the *Drabkin* majority, "[i]f the House intended this passage to provide criteria for determining when property is considered within the debtor's estate and when it is held in trust, we would expect to find the passage in its commentary on section 541, which defines what property is included within the debtor's estate . . . ."[11] *Drabkin*, 824 F.2d at 1112. The court determined that "one reaches the question of whether a payment is for an antecedent debt only after having concluded that funds were property of the estate [as defined in §541] at the time of payment." *Id.*[12]

10. The dissent disagreed with the *Drabkin* majority for transforming a §547(b) preferential transfer case into a case in which section 541's definition of 'property of the estate' becomes the central focus. 824 F.2d at 1118 (Ruth Bader Ginsburg, J. dissenting). Indeed, the dissent postulated that "the question the majority poses – 'whether the payment was of estate property or of trust funds' – was not the issue Congress wanted courts to resolve when faced with *pre-petition* withholding tax payments." *Id.* at 1119 (citation omitted; emphasis in original). The dissent explained:

> True enough, '[i]f the funds in question were trust funds' – i.e. were not 'property of the estate' under section 541 – 'their pre-petition payment [could] never be a voidable preference.' Court's opinion at 1112. It does not follow as the night the day, however, that if the funds were property of the estate, then the pre-petition payment would be a voidable preference.

Id. at 1118-19 (Ruth B. Ginsburg, J, dissenting).

11. The *Drabkin* majority found unconvincing the House Report's discussion of withholding taxes under §547(b) because it was in the "wrong place" in the Report. Furthermore, it believed the passage to be only an elaboration of the observation that precedes it regarding tax payments made on account of an antecedent debt. 824 F.2d at 1112. We disagree. The passage specifically refers to a payment of withholding taxes as "a payment of money held in trust" with respect to which the taxing authority is "in a separate class," and therefore evinces Congress's intent to treat withholding taxes differently than other taxes. Given the passage's broad implication, we find that it is plainly more than an elaboration on the relationship between the timing of the payment and the incurrence of the debt.

12. The court explained:

> The fact that the much contested passage arises in a discussion of the

The IRS asks us to find that withheld taxes transferred pre-petition may not be defined as "property of the estate." In particular, the IRS argues that the language of the House Report discussing §547(b) reflects congressional intent that the pre-petition payment of withholding taxes identifies those taxes as funds held in trust. As funds held in trust, they could not be defined as "property of the estate" under §541, and consequently their transfers could not be avoided as preferential under §547(b).[13] As we have noted, the *Drabkin* majority declined to interpret the House Report discussion of §547(b) in this manner because it appeared in the "wrong place" in the legislative history.

However, we believe that the placement of this passage in the Report's discussion of §547(b) rather than in the discussion on the definition of "property of the estate" under §541 does not diminish its relevance. We find that the House Report's discussion of §547(b) indicates that, at least pre-petition, the act of payment of withholding taxes identifies those taxes as funds held in trust. As funds held in trust, these withholding taxes paid pre-petition are not property of the estate under §541.

NOTES *(Continued)*

section 547 preference rules strongly suggests (1) that the House did not intend it to illuminate what constitutes a trust under section 541, and (2) that pre-petition payments of withheld taxes might qualify as voidable preferences, at least under some circumstances.

Drabkin, 824 F.2d at 1112.

13. The Bankruptcy Code does not define the phrase "property of the debtor" found in §547(b). Therefore, courts have looked to whether the transferred property may be defined as "property of the estate" under §541. Indeed, to constitute a preference under §547(b), a transfer must deprive the debtor's estate of property that could otherwise be used to satisfy creditors. *In re Newcomb*, 744 F.2d 621, 626 (8th Cir. 1984); *see also* 4 *Colliers on Bankruptcy* ¶547.03[2] (1989) ("A transfer is preferential only if the property or the interest in property transferred belongs to the debtor. . . . The fundamental inquiry is whether the transfer diminished or depleted the debtor's estate.").

The *Drabkin* majority also identified other portions of the Bankruptcy Code's legislative history as illustrative of congressional intent regarding pre-petition payments of withholding taxes, including the Committee Report's discussion of section 547(c):

> In the tax content, this exception [§547(c)] will mean that a payment of taxes when they are due, either originally or under an extension, or within 45 days thereafter, will not constitute a voidable preference. However, if a payment is made later than the last day on which the tax may be paid without penalty, then the payment may constitute a preference, if the other elements of a preference are present. In that case, the tax debt would be an antecedent debt and would not fall under this exception. However, the trustee would be able to recover only if the taxing authority did not have sovereign immunity or had waived it under proposed 11 U.S.C. 106.

1978 U.S. Code Cong. & Admin. News at 6329. The trustee asks us to find, as the *Drabkin* majority found, that this passage makes clear that Congress intended, in some circumstances, for pre-petition tax payments to be recoverable as voidable preferences. 824 F.2d at 1113. The *Drabkin* majority explained that the Report's commentary on §547(c) quoted above, when read in conjunction with the Report's discussion of §547(b), manifests legislative intent that the phrase "as they will have been if the debtor is able to make the payments" made in the Report's commentary on §547(b) "presupposes payments made before a penalty is incurred, *not* whenever the debtor happens to make the payment."[14] *Id.* (emphasis in original).

14. Accordingly, because the tax payments at issue in *Drakin* were made by Auto-Train months after the taxes had become due, and were not protected from avoidance under §547(c)(2) because they were made within 45 days after the payments were due, the *Drabkin* court allowed the trustee to recover as preferential the tax payments made by Auto-Train prior to its petition for bankruptcy. The court continued: "When the payment occurs after that 45-day period, as here, it qualifies as a voidable preference under §547(b)-(c) *unless* the funds used are traceable to a trust and therefore excluded from the debtor's estate under section 541." 824 F.2d at 1115 (emphasis in original).

We find, however, that the Report's discussion of §547(c) makes no distinction between taxes on income earned by the debtor itself and taxes of others withheld by the debtor. In contrast, the House Report's discussion of §547(b) directly addresses the issue of withholding taxes. As the *Razorback* court explained, taxes that an employer has an obligation to withhold from others are distinguishable from the taxes on income earned by the employer:

> [Withholding] taxes are ordinarily never considered property of the employer having the duty to withhold. Initially, the tax monies are the property of the employees from whose wages the monies are withheld, and after the withholding is accomplished, 26 U.S.C. Section 7501(a) provides that the monies belong to the United States and are held in trust by the employer.

45 B.R. at 920; *see also In re Rodriguez*, 50 B.R. at 581; *Kalb v. United States*, 505 F.2d 506, 509 (2d Cir. 1974) (in paying withholding taxes over to the government, the employer merely surrenders that which does not belong to him), *cert. denied*, 421 U.S. 979 (1975); Heffron, *Fraud in Withholding*, 18 Inst. on Fed. Tax. 1073, 1076 (1960) ("The gross wages belong to the employee; but for the intervention of [withholding tax] law all would be paid to him."); *cf. In re Ribs-R-Us, Inc.*, 828 F.2d 199, 200 (3d Cir. 1987) (withheld taxes commonly referred to as "trust fund taxes"). Thus, withholding taxes are distinguished from taxes directly incurred by the debtor. Indeed, the IRS does not dispute that payments of non-"trust fund taxes," such as corporate income taxes, Federal Unemployment Tax Act taxes, and the employer's share of FICA taxes, would be subject to a preference action. We believe our holding reflects a proper consideration of the distinct nature of withholding taxes.

E.

In a similar way, the *Drabkin* majority did not distinguish between pre-petition payment of withheld taxes and a post-petition action by the IRS to recover withheld taxes in the possession of the estate. Focusing on the legislative history of

§541, the *Drabkin* majority found that Congress intended to relax *Randall's* strict tracing requirements to allow courts to permit the use of "reasonable assumptions" under which taxing authorities may demonstrate that amounts of withheld taxes are in the possession of the debtor at the commencement of the case. 824 F.2d at 1106. The *Drabkin* majority then concluded that, in the context of the case before it concerning pre-petition payments of withholding taxes, the question presented involved "the precise extent to which Congress relaxed [the tracing] requirement" through the use of "reasonable assumptions."[15] 824 F.2d at 1112. Finally, the court determined that the reasonable assumption, rather than the strict tracing rule of prior law should govern, and held that it was not a reasonable assumption to " 'conclusively presume that the funds used for payment necessarily are endowed with trust characteristics.' " *Id.* (citing Olympic Foundry, 63 B.R. at 329).

The dissent found inapposite the majority's emphasis on the "reasonable assumption" tracing burden imposed by Congress in response to the *Randall* case. *Drabkin*, 824 F.2d at 1119 (Ruth B. Ginsburg, J., dissenting). We agree. We believe that, when Congress relaxed *Randall's* tracing requirement to allow courts to use "reasonable assumptions" to trace funds, it intended the reasonable assumption tracing burden to apply post-petition only. This is clear from the legislative history: "The courts should permit the use of reasonable assumptions under which the Internal Revenue Service, and other tax authorities, can demonstrate that amounts of withheld taxes are still in the possession of the debtor at the commencement of the case." *See supra* statements of Representative Edwards and Senator DeConcini.

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15. The *Drabkin* majority addressed the question whether the "reasonable assumption" tracing requirement would apply to pre-petition withholding tax payments after concluding that, "when the [withholding tax] payment occurs after [the] 45-day period [under §547(c)(2)(B)], . . . it qualifies as a voidable preference under section 547(b)-(c) *unless* the funds used are traceable to a trust and therefore are excluded from the debtor's estate under section 541." 824 F.2d at 1112.

III.

We conclude, in accordance with congressional intent embodied in the legislative history, that the debtor's pre-petition payments on account of its tax withholding obligations are held to be a special fund in trust for the IRS for the government under I.R.C. §7501 and are not preferential transfers of the debtor's property under 11 U.S.C. §547(b).

Therefore, we will reverse and remand to the district court for further proceedings consistent with this opinion.

HUTCHINSON, *Circuit Judge,* Dissenting.

I would affirm the order of the district court for the reasons set forth in the majority opinion of Judge Douglas Ginsburg for the District of Columbia Circuit in *Drabkin v. District of Columbia*, 824 F.2d 1102 (D.C. Cir. 1987).

A True Copy:
Teste:

Clerk of the United States Court of Appeals
for the Third Circuit

Filed: July 13, 1989
FOR PUBLICATION

UNITED STATES COURT OF APPEALS
FOR THE THIRD CIRCUIT

No. 88-1788

HARRY P. BEGIER, JR., Trustee

v.

UNITED STATES OF AMERICA
INTERNAL REVENUE SERVICE,

Appellant

Appeal from the United States District Court
For the Eastern District of Pennsylvania
(D. C. Civil No. 88-3529)

Argued January 31, 1989

Before HUTCHINSON, SCIRICA and
NYGAARD, *Circuit Judges*

ORDER AMENDING SLIP OPINION

IT IS HEREBY ORDERED that the slip opinion in the above case, filed June 30, 1989, be amended as follows:

at page 4, line 4, delete the words "Chapter 7" and insert the words "Chapter 11."

BY THE COURT,

/s/ Anthony J. Scirica
Circuit Judge

DATED: July 13, 1989

A True Copy:
Teste:

Clerk of the United States Court of Appeals
for the Third Circuit

UNITED STATES DISTRICT COURT
EASTERN DISTRICT OF PENNSYLVANIA

IN RE:		
AMERICAN INTERNATIONAL AIRWAYS, INC.	)	BANKRUPTCY NO. 84-02379K
Debtor	)	
HARRY P. BEGIER, JR., TRUSTEE,	)	Civil Action 88-3529
Plaintiff,	)	
vs.	)	Philadelphia, Pennsylvania August 15, 1988
UNITED STATES OF AMERIGA INTERNAL REVENUE SERVICE,	)	9:30 a.m.
Defendant.	)	

TRANSCRIPT OF HEARING
BEFORE THE HONORABLE DONALD W. VAN ARTSDALEN
UNITED STATES DISTRICT JUDGE

APPEARENCES:

For the Plaintiff:	PAUL WINTERHALTER, ESQUIRE 1900 Spruce Street Philadelphia, PA 19103
For the Defendant:	STUART J. GLICK, ESQUIRE Trial Atty., Tax Division U.S. Department of Justice P.O. Box 227 Ben Franklin Station Washington, D.C. 20044
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Proceedings recorded by Electronic Sound Recording; transcript produced by transcription service.

• • •

Thank you, Your Honor.

THE COURT: All right. Thank you very much. Gentlemen, in this case, of course, we're primarily concerned with the interpretation of 11 USC, section 541 and – or 547 rather. The statute itself is plainly not very helpful and, therefore, there has been a great attempt by every one who has been faced with this to try to determine the legislative intent based upon the various statements that were made at the time and there have been different interpretations made from this.

The once case that both parties cite, that is certainly the most extensive on the interpretation of the statute, is *Drabkin versus District of Columbia*, reported in 824 Federal Reporter 2d, page 1102. It is a likely opinion and although the facts don't exactly fit the present case, they certainly – the discussion, of course, covers the issues that are involved here. Although, I find it difficult to reach any final conclusion as to just what the *Drabkin* court would have done were it faced with the situation presently here. It would seem to me that in – that there has to be established that the funds are in some way held in trust before the IRS can retain those particular funds which were paid to it during the period of time when it would be subject to – otherwise to an avoidance as a preference. I think it's clear under present law that the IRS does not hold any particular advantage over any other creditor, so far as avoidance of preferences are concerned.

The Government in this case takes the position that it is the burden – the burden is upon the debtor or the trustee, rather, to establish that they are entitled to recover the funds. In general, that would be correct, of course, but I think that all that the trustee has to show are the – so far as the issues of this case are concerned, is that the funds that were used did belong to the estate or were the property of the estate before they payment was made. And, clearly, that – that issue has been established. After that it seems to me that it then becomes the burden of the IRS to establish that in some way this was trust fund property and that, of course, is what the Government has tried to

contend. As I understand the Government's argument, although it may be overly simplified, it is because the legislative intent makes it clear that the Government could, or the IRS could have reasonable assumptions applied in determining whether or not there are trust funds set up, that the mere fact that there wasn't a payment made out of commingled funds establishes that it was trust property. I know that the Government has said no. They don't really take that extreme position but they say that once they establish that, then it would be up to the trustee to establish in some way that that would not be a reasonable assumption under the facts of the particular case by showing that the funds had in some way been segregated. IRS obviously has some difference from an ordinary creditor because the Internal Revenue statutes provide that the debtor or the trustee is required to, as are all taxpayers, to hold withholding taxes and employees – employees share of the FI – of the, I believe it's the FICA taxes, in trust. And, of course, at one time, I think previously, the U.S. Supreme Court *In RE Randall – United States versus Randall*, rather, 401 US 513, ruled that that provision took priority over the bankruptcy statute. That of course has since been changed by the new bankruptcy code and it's clear now that there is not an absolute priority but in doing that the legislate – legislative intent would appear to be that some advantage, such as the applying of reasonable assumptions, should be made. I'm not quite sure just what reasonable assumptions there would have to be shown, but I do not think that it would be sufficient for the IRS to reclaim money that was clearly from commingled funds simply on the basis that it would be reasonable to assume that since the payments were made that that was sufficient evidence that the funds had been held in trust.

There are cases that go both ways on this issue. It's a matter obviously that will at some point or other have to be addressed by the appellate courts. I read Judge Scholl's opinion. It is quite thorough and explains, I think, the situation quite well, although the real issues that are involved in this appeal do not require any great discussion or even understanding of where the particular funds came from or when they were made.

So far as the issues involved here, I think that it is simply a matter that there were commingled funds. That payments were made to the IRS out of these commingled funds within the statutory period for which an avoidance would ordinarily be proper. Certainly would be if it were an ordinary creditor. I'm going to affirm the decision of Judge Scholl on the basic issue. That is as to the decision which was in favor of the trustee in this case. I don't think that this requires as strict a tracing as what the IRS apparently concludes was intended by Judge Scholl's opinion. I do think, however, that it requires some evidence beyond – that that must be shown by the IRS, some evidence beyond that of merely having made the payment. Which, so far as I can see in this case is the only evidence that there is that there was a payment made out of commingled funds.

Now a stipulation of facts was originally entered into in this matter between the parties before the bankruptcy judge. Briefs, I gather, were prepared on the basis of that stipulation by the trustee. The Government then – or the IRS recognized that there were certain facts that weren't fully set forth in the – in the stipulation of facts or would have allowed different arguments to be made and they wanted to have a supplement to the stipulation of facts, which would not be agreed upon and, therefore, there was required to be a evidentiary hearing and further briefing. As a reason for that, the Bankruptcy Judge, Judge Scholl, placed the attorneys fees on the IRS on the basis of Bankruptcy Rule 9011, which is very similar to the Federal Rule of the Civil Procedure 11. I – certainly there's no evidence that the Government did, or the IRS did anything in this case but act in good faith. It was a matter that was simply overlooked, I gather, in preparing the original stipulation of facts. The only possible basis that I can see for imposing the attorney's fees on the – on the IRS would be that – that of Rule 9011, which if it is like Rule 11, certainly would – could not be properly interpreted as requiring or allowing the award of attorneys fees. So that it could only be based on some general equitable principles which the Bankruptcy Judge applied. I don't know of any law or case that says on general equitable principles the attorneys fees for any particular portion of a case

may be imposed upon the opposing – one party or the other. And, therefore, as to the imposition of the $375 attorney's fee, I am going to and I do reverse the decision of the Bankruptcy Judge. By doing that and because that matter is considered here on the merits, I don't think it's necessary to go into the reason for denying the motion for reconsideration, which Judge Scholl stated was filed late. It would appear that it was not filed late but that is not necessary to decide at this point. So I am affirming the Bankruptcy Court on its decision as to the avoidance issue and will reverse on the fee – attorney's fee charge of $375. All right. Thank you very much.

One further thing. As I say, there are cases on both sides on this matter. It seems to me it's a very close case and it's a matter of how, I suppose, one interprets what the – what Congress intended and that's always a very difficult and hazardous guess on the part of Courts. So that I think this is a case that might well be d always a very difficult and hazardous guess on the part of courts. So that I think this is a case that might well be decided by different judges in a different way and I can understand that. All right. Thank you very much.

MR. WINTERHALTER: Thank you, Your Honor.

MR. GLICK: Thank you, Your Honor.

CERTIFICATION

I, JoAnn Stott, certify that the foregoing is a correct transcript from the electronic sound recording of the proceedings in the above-entitled matter.

JO ANN STOTT Date

* * *

UNITED STATES BANKRUPTCY COURT
FOR THE EASTERN DISTRICT OF PENNSYLVANIA

In re: AMERICAN INTERNATIONAL AIRWAYS, INC. Debtor	:	Chapter 11 Bankruptcy No. 84-02379K
HARRY P. BEGIER, JR., TRUSTEE Plaintiff	:	
v.	:	
UNITED STATES OF AMERICA, INTERNAL REVENUE SERVICE Defendant	:	Adversary No. 86-1076K

OPINION

A. INTRODUCTION AND PROCEDURAL HISTORY

The instant proceeding is an action in which the Trustee of a defunct commercial airline now a Chapter 11 Debtor seeks to avoid alleged preferential transfers by the Debtor of substantial sums (approaching $1 million) to the Internal Revenue Service (hereinafter referred to as "IRS"). Herein, we revisit a factual pattern which we addressed in a previous Opinion in this case reported at 70 B.R. 102 (Bankr. E.D.Pa. 1987) (referred to hereinafter as *"IRS Trust"*),[1] and legal issues which we addressed in an Opinion arising out of another proceeding to avoid an alleged preferential transfers to another party in this same case, reported at 68 B.R. 326 (Bankr. E.D.Pa. 1987) (referred to hereinafter as *"Krain"*).[2] We hold that the Trustee is entitled to avoid transfers in the sum of $700,410.33 out of transfers totaling $1,641,434.06.

The underlying Chapter 11 bankruptcy case was filed on July 19, 1984. In the early stages of the case, the Debtor

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1. We utilize this designation because we concluded therein that the IRS could successfully assert a trust as to funds segregated in an account established pursuant to 26 U.S.C. §7512.

2. This designation is taken from the name of the Defendant in that adversarial proceeding, Krain Outdoor Advertising, Inc.

attempted to remain in business as a debtor-in-possession. However, by September 19, 1984, the Plaintiff in this proceeding had been appointed as Trustee, and the case has thereafter progressed in a liquidation mode. *See In re American International Airways, Inc.*, 74 B.R. 691, 692-93 (Bankr. E.D.Pa. 1987).

The instant proceeding was commenced by the Trustee on September 18, 1987, seeking to recover funds transferred to the IRS in three separate transactions totalling $946,434.06. The Complaint was later amended to include a fourth transfer of $695,000.00, the sum ultimately ascertained to have been deposited into the trust fund account discussed in the *IRS Trust* Opinion.

On February 11, 1987, the IRS filed a Motion for Judgment on the Pleadings or, alternatively, for Summary Judgment in its favor as its initial response to the Complaint. However, the IRS shortly thereafter agreed to withdraw this motion, and, on May 19, 1987, we entered a Pre-trial Order scheduling a trial on August 6, 1987. On that date, the parties advised that they had intended to prepare a Stipulation of Facts and would thereafter file a supplemental Stipulation of Facts, all of which would constitute the record. Accordingly, on August 7, 1987, they filed their initial Stipulation of Facts, and, on September 1, 1987, we entered an Order providing that the supplemental Stipulation would be filed by September 11, 1987, and that briefing, to be completed by October 28, 1987, would follow.

However, in the midst of the briefing, on October 15, 1987, the IRS filed a Motion to Clarify or Grant Relief from the initial Stipulation of Facts, contending that it had erred in its agreement therein as to the Debtor's filing status. We granted that motion over the Trustee's objection in an Order of October 21, 1987, although we did require the IRS to pay $375.00 to the Trustee for causing him to spend time preparing a brief which relied upon the Stipulation as its factual basis. On October 21, 1987, we also entered a Second Pre-trial Order, scheduling a potential evidentiary hearing, if necessary in light of this modification of the Stipulation, on November 17, 1987.

The hearing was in fact conducted on November 17, 1987. The Trustee called George L. Miller, an accountant who was appointed as "financial management consultant" for the Trustee on July 29, 1985, as his sole witness. The IRS called Alan D. Zlatkin, a revenue officer in its collection division who had serviced the Debtor's account in the pertinent early 1984 period, as its sole witness. After the hearing, the Trustee requested an opportunity to obtain a copy of the transcript before preparing further briefs. Accordingly, we entered an Order of November 18, 1987, allowing the parties to submit their respective briefs at twenty-day intervals subsequent to completion of the transcript. The transcript was not completed until early January, 1988, extending the briefing through February 22, 1988.

In the course of the briefing, the Trustee discovered a letter of May 1, 1984, from Mr. Zlatkin to Bruce Edmondson, the Debtor's chief operating officer, and he moved to open the record to add it. By Stipulation of February 2, 1988, the letter was added to the record by agreement.

Although there were certain factual disputes which the parties believed to be material between them, resulting in the November 17, 1987, hearing, we do not believe that these factual disputes had any significant bearing on our ultimate disposition. Nevertheless, per the dictates of Bankruptcy Rule 7052 and Federal Rule of Civil Procedure 52(a), we are preparing our Opinion in the format of Findings of Fact, Conclusions of Law, and a Discussion.

B. FINDINGS OF FACT

1. On February 22, 1984, Mr. Zlatkin's office prepared a letter to Mr. Edmondson, informing him that, "effective for the month of March, 1984, . . . for the first quarter of 1984 by April 15, 1984," the Debtor was obliged to file monthly, as opposed to quarterly, returns for its Form 941 employment taxes, covering employees FICA and federal income tax withheld by the Debtor (referred to hereinafter as "withholding taxes"), and for its Form 720 excise taxes (referred to hereinafter as "excise taxes").

2. Although the letter was erroneously sent out prior to March 1, 1984, on the latter date it was properly hand-delivered to Mr. Edmondson by Mr. Zlatkin, with a notice also requiring the Debtor to "immediately" establish a separate bank account in which to make deposits of future amounts due for withholding and excise taxes as trustee for the IRS, pursuant to 26 U.S.C. §7512.

3. The Debtor wrote to the IRS on March 6, 1984, advising that it had that day established a trust fund account as directed in Industrial Valley Bank and Trust Co., at Account No. 802-304-2.

4. Although, according to Mr. Zlatkin, the Debtor was not required, per the terms of the letter, to begin filing monthly returns until April, 1984, the Debtor nevertheless proceeded to file returns for January and February, 1984, on March 15, 1984.

5. The Debtor did make certain deposits into the trust account through the end of April, 1984, after opening this account.

6. Withholding taxes must be paid to the IRS within three business days after the payroll from which the taxes are withheld, or a penalty is imposed upon the taxpayer-employer.

7. There is no statement in the record as to whether or when a penalty is imposed for late payment of excise taxes.

8. The penalty for late payment of withholding taxes is not assessed until the employer's returns are filed. However, unless the employer is granted an extension or some other dispensation, the penalty is assessed at the time of the filing of the return if the payment is not made in timely fashion.

9. The Debtor remitted the following payments in issue to the IRS:

a. April 30, 1984 – $695,000.00 from the trust fund account.

b. April 30, 1984 – $734,797.71 from one of the Debtor's general accounts.

c. June 22, 1984 – $200,000.00 from the same general account.

d. June 27, 1987 – $11,636.35 from the same general account.

10. The above payments were allocated, respectively, as follows:

a. Both April 30, 1984 payments (allocation not designated between them):

(1) $259,992.98, for full payment of January, 1984, withholding taxes;

(2) $228,781.00, for full payment of February, 1984, withholding taxes;

(3) $102,360.01, for full payment of February, 1984 excise taxes;

(4) $105,765.68, for part payment of March, 1984, withholding taxes;

(5) $203,000.33, for full payment of March, 1984, excise taxes;

(6) $300,000.00, for current April, 1984 withholding taxes; and

(7) $229,797.71, for current April, 1984, excise taxes.

b. June 22, 1984, payments – for first quarter, 1984, withholding taxes.

c. June 27, 1984, payment – for certain 1982 and 1983 taxes.

11. The trust account, having been established on March 6, 1984, to pay taxes collectible only after its existence, could not have been utilized as a depository for any taxes collectible earlier than March, 1984.

12. All withholding taxes due in January, 1984, and February, 1984, totalling $488,773.98, were collectible earlier than March, 1984; could not have been made out of trust funds; and hence cannot be allocated to the $695,000.00 payment.

13. The record does not contain facts sufficient to conclude that any of the other sums paid on April 30, 1984, necessarily would had to have been allocated from either of the two April 30, 1984, payments.

14. The parties stipulated that the Debtor was insolvent as of the date of all of the transfers and that the requirement of 11 U.S.C. §547(b)(5) was met as to all of the transfers.

C. CONCLUSIONS OF LAW

1. The $695,000.00 payment out of trust funds cannot be reached by the Trustee. However, no other funds paid to the IRS can be similarly classified as trust funds, and hence the Trustee can recover any other payments as preferential to the extent that he can prove that all of the elements of 11 U.S.C. §547(b) were present and that no defense pursuant to 11 U.S.C. §547(c) can be proven by the IRS as to these other payments.

2. A tax debt is "incurred," per §547(a)(4), when penalties are imposed, irrespective of when the returns for that tax are due. The returns for all taxes from January, 1984, and February, 1984, were due as of April 15, 1984, prior to the payments of April 30, 1984. Hence, there is no question that all of the tax obligations for January, 1984, and February, 1984, were "antecedent debts," pursuant to 11 U.S.C §547(b)(2).

3. All of the requirements of 11 U.S.C. §547(b) were therefore met as to the portion of the transfers of April 30, 1984, which were credited to any January, 1984, and February, 1984, taxes, as well as to the two subsequent June, 1984 transfers.

4. The IRS has not met its burden of proving that the April 30, 1984, payments made towards any January, 1984, and February 1984, tax obligations were made within forty-five (45) days of the date when the debts were incurred, per §547(a)(4), and certainly it cannot prove this as to either of the June, 1984, payments. Therefore, the IRS is not able to prove the element of former 11 U.S.C. §547(c)(2)(B), which is applicable to this case, i.e., that the payments were made not later than forty-five (45) days from when the debts were incurred.

5. However, assuming *arguendo* that it could have met its burden of proving the element of former §547(c)(2)(B), the IRS must additionally prove all of the other elements of §547(c)(2) to succeed in asserting this Code section as a defense. It has failed to prove that the Debtor made any of the payments in the ordinary course of the affairs between the parties or according to ordinary business terms, as required by former 11 U.S.C. §§547(c)(2)(C) and (c)(2)(D), respectively. Consequently, the IRS has not proven the existence of a §547(c)(2) defense as to any of the relevant transfers.

6. Therefore, except to the extent that it is able to argue that certain of the portions of the $695,000.00 trust fund payment could be allocated to taxes collectible prior to March, 1984, the IRS has no viable defenses to the Trustee's claims.

7. The IRS cannot argue that the January, 1984, and February, 1984, withholding taxes paid with the April 30, 1984, funds could possibly have been allocated to the trust fund payment, because those taxes were collectible prior to the establishment of the trust fund.

8. There is no evidence that any other taxes paid on April 30, 1984, could not be allocated to either of the two sources of the April 30, 1984, payments.

9. The IRS is empowered to allocate the remainder of the total April 30, 1984, payments, exclusive of the January, 1984, and February, 1984, withholding taxes (total = $1,429,797.71; remainder = $941,023.71) however it wishes. It is therefore entitled to allocate the $695,000.00 payment to any of the taxes paid in April except those on account of the January, 1984, and February, 1984, withholding taxes.

10. The trustee is therefore entitled to avoid the transfer of only that portion of the April 30, 1984, payments attributable to January, 1984, and February, 1984, withholding taxes, i.e., $488,773.98, plus the June, 1984 transfers, which totaled $211,636.35.

11. The Trustee is entitled to judgment in the amount of $700,410.33 against the IRS.

D. DISCUSSION

Our starting point is the observation that payments made by a debtor on tax obligations are subject to avoidance as preferential transfers, like any other transfers which meet the following criteria of 11 U.S.C. §547(b):

> (b) Except as provided in subsection (c) of this section, the trustee may avoid any transfer of an interest of the debtor in property—
>
> (1) to or for the benefit of a creditor;
>
> (2) for or on account of an antecedent debt owed by the debtor before such transfer was made;
>
> (3) made while the debtor was insolvent;
>
> (4) made)—
>
> (A) on or within 90 days before the date of the filing of the petition; or
>
> (B) between ninety days and one year before the date of the filing of the petition, if such creditor at the time of such transfer was an insider; and
>
> (5) that enables such creditor to receive more than such creditor would receive if—
>
> (A) the case were a case under chapter 7 of this title;
>
> (B) the transfer had not been made; and
>
> (C) such creditor received payment of such debt to the extent provided by the provisions of this title.

No exception is contained in §547 for payments on taxes. Moreover, 11 U.S.C. §547(a)(4) states that, for purposes of §547, "a debt for a tax is incurred on the day when such tax is last payable without penalty, including any extention." Obviously, if Congress meant to exempt tax payments for the scope of §547,

there would have been no reason to include any provision such as §547(a)(4) in the code. Collier so indicates, when it states that this language *replaced* earlier language which would have exempted tax claims from the scope of §547. *See* 4 COLLIER ON BANKRUPTCY, ¶547.02[4], at 547-16 (15th ed. 1987). The IRS apparently does not dispute this point, as its Supplemental (and final) Memorandum of Law cites with approval to two cases in which payments to the IRS were deemed subject to 11 U.S.C. §547, *In re Cleveland Graphic Reproductions, Inc.*, 78 B.R. 819 (Bankr. N.D.Ohio 1987); and *In re Morris*, 53 B.R. 190 (Bankr. D.Ore. 1985). *See also, e.g., Drabkin v. District of Columbia*, 824 F.2d 1102 (D.C. Cir. 1987); *United States v. Air Florida, Inc.*, 56 B.R. 732 (S.D.Fla. 1985); *In re R & T Roofing Structures & Commercial Framing, Inc.*, 42 B.R. 980, 913-16 (Bankr. D.Nev. 1984); *Cf. In re Miller's Auto Supplies, Inc.*, 75 B.R. 676 (Bankr. E.D.Pa. 1987) (payments on state taxes avoidable as preferential transfers).

The second issue is whether payments for taxes are removed from the property of the Debtor's estate and hence exempt from characterization as preferential transfers because such payments are supposed to be held as trust funds by debtors. We articulated our limited application of this theory in the *IRS Trust* Opinion in this very case, 760 B.R. at 105. *See also In re Rimmer Corp.*, 80 B.R. 337, 338-39 (Bankr. E.D.Pa. 1987); and *Miller, supra*. There, we concluded that only where a tax trust fund is actually etablished by the debtor and the taxing authority is able to trace funds segregated by the debtor in a trust account established for the purpose of paying the taxes in question would we conclude that such funds are not property of the debtor's estate.

We acknowledge several authorities holding to the contrary, i.e., that the mere requirement that the debtor establish a trust account for tax payments exempts any payment for taxes from the scope of property of the estate. *In re Rodriguez*, 50 B.R. 576 (Bankr. E.D.N.Y. 1985); and *In re Razorback Ready-Mix Concrete Co*, 45 B.R. 917 (Bankr. E.D.Ark. 1984). However, the first Court of Appeals addressing the issue in *Drabkin, supra*, not only concurred with our reasoning, but cited our *IRS*

Trust Opinion on this issue with approval. 824 F.2d at 1110 n. 27. Other courts have concurred with our reasoning. *See, e.g., Air Florida, supra; In re Olympic Foundry Co.*, 63 B.R. 324, (Bankr. W.D.Wash. 1986); and *In re Major Dynamics, Inc.*, 59 B.R. 697 (Bankr. S.D.Cal. 1986). We reiterate our belief that the application of the trust fund theory must be limited as we indicated in our prior decisions.

This observation resolves the issue as to whether the June, 1984, transfers were preferential payments. The only argument made by the IRS as to why these payments should not be deemed preferential is the broad reading of the trust theory espoused by *Rodriguez, supra,* and *Razorback, supra,* and rejected by us. Therefore, the Trustee is clearly entitled to judgment in his favor as to the $211,636.35 paid to the IRS by the Debtor in June, 1984.

The April 30, 1984, transfers are, of course, far more difficult to analyze. On one hand, the Trustee argues that the entire amount of $734,797.71 remitted from the Debtor's general account represented a preferential transfer. The IRS, meanwhile, contends that it can allocate the entire $695,000.00 trust fund to the January and February, 1984, taxes and that, viewing the $734,797.71 as allocated to only March and April, 1984, taxes, none of the payments from the Debtor's general account were preferential. The first building block of the IRS's argument is its contention that none of the Debtor's first quarter, 1984, taxes were incurred until its returns were due on April 15, 1984, and that, since the returns for the April, 1984, taxes were not yet due, the April, 1984, tax obligations were not antecedent debts, per 11 U.S.C. §547(b)(2). The second building block is its contention that 11 U.S.C. §547(c)(2), the applicable version of which provided as follows,[3] establishes a defense as to all of the Debtor's tax payments for the first quarter of 1984:

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3. The pre-1984 version of the Code applies to this case because it was initiated prior to the effective date of the 1984 amendments. *See Krain, supra,* 68 B.R. at 327-28 & n. 2.

(c) The trustee may not avoid under this section a transfer—

. . .

(2) to the extent that such transfer was—

(A) in payment of a debt incurred in the ordinary course of business or financial affairs of the debtor and the transferee;

(B) made not later than 45 days after such debt was incurred;

(C) made in the ordinary course of business or financial affairs of the debtor and the transferee; and

(D) made according to ordinary business terms; . . .

The first question which must be resolved is when a tax debt is deemed to be "incurred." As we indicated at page 12 *supra*, §547(a)(4) gives explicit guidance on this point, stating that it is incurred when it is "last payable without penalty, including any extension." The parties dispute the meaning of this seemingly simple language when applied to federal withholding taxes. The Debtor contends that it means that as soon as a penalty is imposed, which occurs if payment is not made within three business days of the taxpayer's payroll, the tax debt is "incurred." The IRS, focusing on the term "payable," contends that it means that a tax debt is not incurred until the returns from that tax are due.

Assuming *arguendo* that the IRS is correct in its contention that the date that returns are filed is significant leads to a further dispute as to whether the letter of February 22, 1984, required the Debtor to begin making monthly returns in March, 1984, or April, 1984. The IRS contends that the effective date of the letter was April, 1984, and hence, despite the Debtor's alleged misinterpretation which caused it to make the filing for January and February on March 15, 1984, the returns for the first quarter of 1984 were not in fact due until April 15, 1984. The

IRS then argues that none of the taxes for the first quarter of 1984 were "incurred" until April 15, 1984, a date preceding the Debtor's payment by only fifteen (15) days. Thus, the IRS concludes that it met the requirement of former §547(c)(2)(B).[4]

Our research reveals that interpretation of §547(a)(4) is almost non-existent. Collier accurately states that "Congress provided little explanation for this provision."[5] COLLIER, *supra*. The *only* case which our exhaustive research had indicated has ever been purported to interpret this provision is *Drabkin*, *supra*, where the court states that, if the debtor's tax payment "had been made within 45 days after the penalty period began, then the Trustee could not recover the payment." 824 F.2d at 1115.

This statement by the court in *Drabkin* supports the Trustee's interpretation, as does, we believe, the clear language of §547(a)(4), which references the imposition of penalty as the significant event. The fact that the penalty, though imposed, is not assessed until later, appears irrelevant. It is the *imposition of the penalty* which the statute indicates is significant.

Finally, the interpretation of the Trustee is consistent with the "classic statement" of when a debt is incurred for purposes of §547(c)(2) in *In re Emerald Oil Co.*, 695 F.2d 833, 837 (5th Cir. 1983), i.e., on the date that the debtor becomes liable for a debt, not the date on which an invoice is prepared or on which the debtor is billed. *See Krain*, *supra*, 68 B.R. at 332; and *In re Art Shirt, Ltd.*, 68 B.R. 316, 324 (Bankr. E.D.Pa. 1986) (both cases cite numerous cases following *Emerald*). The date of imposition of the penalty appears to us to be comparable to the date that liability is imposed. The date that the return is due

4. The IRS appears to erroneously argue that, if it meets the requirement of §547(c)(2)(B), it has established a §547(c)(2) defense. This is, of course, not so, because the four requirements of §547(c)(2) are set forth in the conjunctive, not the disjunctive. *See* page 20 *infra*.

5. Actually, Congress appears to have given equivocal explanations of this provision. *See* page 17 & 18 n. 6 *infra*.

appears comparable to the preparation of an invoice of amounts due for an already-imposed liability.[6]

We therefore conclude that, for purposes of §547(a)(4), tax debts are incurred as soon as penalties are imposed. It is undisputed that penalties for failing to pay withholding taxes are imposed if payments for the taxes are not remitted within three business days from the date that the taxpayer makes its payroll. It is therefore clear to us that the January and February, 1984, withholding taxes were incurred prior to the opening of the IRS trust account as a depository for payments on of future tax liabilities of the Debtor on March 6, 1984.

Furthermore, the January and February, 1984, withholding taxes cannot be allocated to the trust account payment. As 26 U.S.C. §7512(b) makes clear, is only tax liabilities "which become collectible after delivery of . . . notice" to establish a trust fund which are to be deposited into such an account. *See United States v. Stevenson*, 540 F.Supp. 93, 95 (D.Del. 1982)

6. The IRS, in its initial brief and at argument after the trial on November 17, 1987, asserts authority for its interpretation in the reports to the houses of Congress on the compromises effected in the enactment of the final bill relating to §547(c)(2)(B) which stated that "the 45-day period referred to in [Section] 547(c)(2)(B) is to begin running in the case of taxes from the last due date, including extensions, of the return to which the tax payment is made." 124 CONG. REC. H 11114 (daily ed. Sept. 28, 1978); S 17431 (daily ed. Oct. 6, 1978). However, the earlier House Report, addressing apparently the identical language, states that "if a payment is made later than the last day which the tax may be paid without penalty, then the payment may constitute a preference." H. REP. No. 595, 95th CONG., 1st Sess. 373 (1977).

This legislative history, relating specifically to §547(c)(2)(B), is therefore ambiguous and inconclusive in assisting us to interpret §547(a)(4). we are certainly not prepared to read a reference ot the date of the filing of a tax return into §547(a)(4) when the only reference in the statute itself is to whether a penalty has been incurred.

In any event, irrespective of the legislative history, the statute in issue clearly makes reference to the date that a tax is payable without penalty rather than date of the filing of the return. Where a statute is plain on its face, it must be interpreted as it reads without resort to legislative history *See, e.g., American Tobacco Co. v. Patterson*, 456 U.S. 63, 68 (1982); *Caminetti v. United States*, 242 U.S. 472, 485, 490 (1917); and *United States v. Pennsylvania Environmental Hearing Bd.*, 584 F.2d 1273, 1281 n. 26 (3d Cir. 1978).

("the requirements of section 7512 are directed toward funds withheld *subsequent to* a failure to withhold and a notice delivered in hand") (emphasis in original). The testimony of Mr. Zlatkin clearly establishes that the notice requiring establishment of the trust fund was not delivered to Mr. Edmondson until March 1, 1984, irrespective of the earlier date appearing on it. The trust account was not opened until March 6, 1984. The January and February, 1984, withhholding taxes perforce must have related to taxes incurred *before* the delivery of the notice or the establishment of the fund rather than *subsequent* thereto. Therefore, the deposits in the fund cannot be allocated to the January and February, 1984, withholding taxes paid out of the April 30, 1984, remittances.

We are uncertain as to when the February, 1984, excise taxes were incured, or when any of the March, 1984, and April, 1984, taxes were incurred. We therefore cannot be positive of the allocation of any portion of the $734,797.21 non-trust-fund payment as to any taxes except the January and February, 1984, withholding taxes, in the total sum of $488,773.98. As we indicate in our discussion at pages 24-25 *infra*, the IRS is empowered to allocate the balance of the payments however it chooses, restricting the Trustee to the recovery of $488,733.98 from the April 30, 1984, transfers.

We now return to analysis of 11 U.S.C. §§547(b) and 547(c)(2) of the Code to determine whether our conclusion that the payment of the January and February, 1984, withholding taxes only was preferential is consistent therewith. Admittedly, the only element of §547(b) concerning which the IRS contended that the Trustee had not met his burden, as to any of the non-trust-fund transfers, was §547(b)(2). Clearly, the January and February, 1984, withholding taxes were "antecedent debts" as of April 30, 1984. The only contest on this point was as to the payments on the April, 1984, taxes, which we conclude cannot be avoided in any event.

The final point of analysis is consideration of whether the IRS can defend against the transfer of the payments of January and February, 1984, withholding taxes on the basis of §547(c)(2). First, as is emphasized in *Cleveland Graphic, supra*, 78 B.R. at

822; and *In re Magic Circle Energy Corp.*, 64 B.R. 269, 272 (Bankr. W.D.Okla. 1986), the requirements of §547(c) are set forth in the conjunctive. Therefore, in cases involving the pre-1984-amendment version of §547(c)(2), all four conditions set forth therein must be satisfied to successfully invoke this defense. *See In Re Craig Oil Co.*, 785 F.2d 1563, 1564-65 (11th Cir. 1986); and *In re Naudain*, 32 B.R. 871, 874 (Bankr. E.D.Pa. 1983).

Secondly, the burden of proving all of these elements is squarely upon the IRS. *See In re Production Steel, Inc.*, 54 B.R. 417, 422 (Bankr. M.D.Tenn. 1985); and *In re Ewald Bros., Inc.*, 45 B.R. 52, 56 (Bankr. D.Minn. 1984). *See generally In re Energy Cooperative, Inc.*, 832 F.2d 997, 1004 (7th Cir. 1987); and *Magic Circle, supra*, 64 B.R. at 272.

While the IRS undoubtedly has established the element of §547(c)(2)(A) as to all of the transfers in issue, there is considerable question as to whether it has met its burden as to any of the three remaining elements as to the Debtor's payments of April 30, 1984, toward January and February, 1984, withholding taxes.

The first remaining element, set forth in former §547(c)(2)(B), requires the IRS to establish that payment was made not later than 45 days after the debt was incurred. Since the debts for withholding taxes due in January and February, 1984, were incurred no later than the earliest days of March, 1984, *see* discussion at pages 15-18 *supra*, it is clear that payments remitted on April 30, 1984, *were* made later than 45 days after these particular debts were incurred. The failure to prove this element in itself appears to be fatal to the IRS's §547(c)(2) defense.

However, the IRS has not met its burden of proving the additional elements of §§547(c)(2)(C) or (D), either. As the court in *In re Bourgeous*, 58 B.R. 657, 658 (Bankr. W.D.La. 1986), emphasizes, a creditor defending a preferential transfer claim on the basis of §547(c)(2) must prove that the payment was "in the ordinary course of business of the debtor *and* the transferee" *and* "according to ordinary business terms."As several courts have articulated, these are two discrete tests, the one pertaining

to the "subjective" course of dealings between these particular parties, and the other pertaining to the "objective" normative course of business of similarly-situated parties. *See, e.g., Windsor Communications Group v. Freedom Greeting Card Co.,* 63 B.R. 770, 774-75 (E.D.Pa. 1986), *rev'd,* 815 F.2d 697 (3d Cir. 1987); *In re Steel Improvement Co.,* 79 B.R. 681, 683-85 (Bankr. E.D.Mich. 1987); *Magic Circle, supra,* 64 B.R. at 272-75; and *Production Steel, supra,* 54 B.R. at 422-24.

The IRS presented no evidence of the particular course of dealing between it and the Debtor such as would meet its burden of proving that these transfers were within the "subjective" ordinary course of their past dealings. There were generalized insinuations by Mr. Zlatkin that the Debtor was not a diligent taxpayer prior to the transfers in issue. However, we believe that the burden was upon the IRS to specifically qualify and quantify the parties' past course of dealings relevant to the transfers in issue and show that these transfers were consistent therewith if it wished to satisfy §547(c)(2)(C). This, we believe it totally failed to do.

Finally, to succeed in a §547(c)(2) defense, the IRS was obliged to establish that the Debtor's tax payment record was objectively that of a normal, similarly-situated taxpayer.We agree with the IRS's citation of *Cleveland Graphic, supra,* and *Morris, supra,* to make the point that payment of taxes in due course should not be considered other than objectively "ordinary," irrespective of a Debtor's poor past record of making such payments. However, here, the relevant issue is the converse: can a debtor ever justify a failure to pay taxes in timely fashion as "ordinary," even if making untimely payments was its normal past course of conduct? *Cf. Craig, supra,* 785 F.2d at 1567-68 (lateness is of particular relevance in ascertaining whether payment terms were ordinary). With respect to the payments remitted on April 30, 1984, the "ordinariness" decreases as the period for which taxes are paid becomes more distant. Hence, it is difficult to justify the timeliness, on April 30, 1984, of payments due without penalty three days after the dates that payrolls were made in January and February, 1984. Furthermore, the action of the IRS in invoking 26 U.S.C. §7512

was an extraordinary remedy. Its mere use here implies that the Debtor failed, in substantial part, to meet payment terms which the IRS deemed objectively ordinary.

We therefore conclude that, at least as to the January and February, 1984, withholding tax payments, the IRS has failed to meet its burden of establishing most of the requisite elements of §547(c)(2). The payments for these tax liabilities may therefore be avoided by the Trustee.

However, having determined that the IRS cannot allocate the January and February, 1984, withholding tax payments to the trust fund, we further hold that it *can* allocate the remainder of the payments between those received from the trust fund and those received from the Debtor's general account however it wishes and thus eliminate the prospect of avoidance of any additional preferential transfers.

We agree with the Trustee's argument that the payments made by the Debtor were voluntary, and hence not within the scope of the decision of the Third Circuit Court of Appeals in *In re Ribs-R-Us, Inc.,* 828 F.2d 199 (3d Cir. 1987). (IRS can allocate payments on pre-petition priority tax liabilities because such payments are involuntary.)

However, even as to voluntary payments, the creditor has the right to allocate payments as it sees fit if the debtor abdicates its right to do so. *See Pristas v. Landaus of Plymouth, Inc.,* 742 F.2d 797, 801 (3d Cir. 1984); *In re Comer,* 716 F.2d 168, 175 (3d Cir. 1983); and *Page v. Wilson,* 150 Pa.Super. 427, 433, 28 A.2d 706, 709 (1942). Thus, the IRS should have the right, in the Debtor's failure to do so, to designate allocation of the voluntary payments made by the Debtor to it on April 30, 1984. *See, e.g., National Bank of Commonwealth v. Mechanics' National Bank,* 94 U.S. 437, 439 (1877); and *Wood v. United States,* 808 F.2d 411, 416 (5th Cir. 1987).

The IRS may therefore proceed to allocate the balance of the proceeds of the $695,000.00 trust-fund payments to whatever obligation it chooses, except for the January and February, 1984, withholding tax payments, to which trust fund payments plainly could not be allocated. This right of allocation extends to even the February, 1984, excise taxes, because the Trustee,

although imposed with the burden of establishing all elements of the preferential transfers in issue, has failed to establish when the debt for such taxes was incurred, pursuant to §§547(b)(2) and (a)(4). The entire $695,000.00 trust fund could have been allocated to the February, 1984, excise taxes; the March, 1984, taxes; and almost all of the April, 1984, withholding taxes. The Trustee has also not proven that at least some of the April, 1984, withholding taxes were not payable without penalty as of April 30, 1984, and consequently has not proven that some of these taxes were incurred as of that date. Therefore, the Trustee has not established that the IRS may not allocate any payments except the $488,773.98 from the January and February, 1984, withholding taxes to the payments from the trust fund.

The Trustee is therefore entitled to set aside the preferential transfer of $488,773.98 from the April 30, 1984, payments, and no more, in addition to the $211,636.35 transferred in June, 1984. Therefore, we are entering judgment in favor of the Trustee in the amount of the sum of these figures, $700,410.33, in our accompanying Order.

DAVID A SCHOLL
UNITED STATES BANKRUPTCY JUDGE
3722 United States Court House
Philadelphia, PA 19106-1763

Dated at Philadelphia, PA,
this 9th day of March, 1988.

UNITED STATES BANKRUPTCY COURT
FOR THE EASTERN DISTRICT OF PENNSYLVANIA

In re:	:	Chapter 11
AMERICAN INTERNATIONAL AIRWAYS, INC.	:	
Debtor	:	Bankruptcy No. 84-02379K
HARRY P. BEGIER, JR., TRUSTEE	:	
Plaintiff	:	
v.	:	
UNITED STATES OF AMERICA, INTERNAL REVENUE SERVICE	:	
Defendant	:	Adversary No. 86-1076K

ORDER

AND NOW, this 9th day of March, 1988, upon consideration of the fact stipulations of the parties, evidence adduced at trial of this matter on November 17, 1987, and the various Memoranda submitted by the parties, it is hereby

ORDERED AND DECREED that judgment is entered in favor of the Trustee and Plaintiff, HARRY P. BEGIER, JR., and against the Defendant, UNITED STATES OF AMERICA, INTERNAL REVENUE SERVICE, in the amount of $700,410.33.

DAVID A. SCHOLL
UNITED STATES BANKRUPTCY JUDGE
3722 United States Court House
Philadelphia, PA 19106-1763

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IN THE UNITED STATES BANKRUPTCY COURT FOR THE EASTERN DISTRICT OF PENNSYLVANIA

In re:	:	Chapter 11
AMERICAN INTERNATIONAL AIRWAYS, INC.	:	
Debtor.	:	Bankruptcy No. 84-02379K
HARRY P. BEGIER, TRUSTEE	:	
Plaintiff,	:	
v.	:	
UNITED STATES OF AMERICA; INTERNAL REVENUE SERVICE,	:	
Defendants.	:	Adversary No. 86-1076

STIPULATION OF FACTS

The plaintiff, Harry P. Begier, Trustee, and the defendants, the United States of America and its Internal Revenue Service, by and through counsel, do hereby stipulate and agree as follows:

1. On April 30, 1984, the Internal Revenue Service received a payment of $1,429,797.71 (hereinafter referred to a "Payment 1") which consisted of a $734,797.71 check drawn from a checking account of the debtor at Industrial Valley Bank ("IVB") (Account No. 0-898-897-8) and a $695,000 Treasurer's Check from IVB, the source of which was funds drawn from another checking account at IVB, Account No. 0-802-304-2. The Court previously ruled on February 20, 1987, that the debtor's Account No. 0-802-304-2 at IVB was an account established pursuant to 26 U.S.C., Section 7512 which was a designated account with the debtor as trustee for the United States and into which the debtor deposited unpaid Federal excise and withholding taxes so that monies contained in such account were not part of the bankruptcy estate.

2. Pursuant to an agreement entered into by the Internal Revenue Service and the Debtor, Payment 1 was applied as follows:

a. $259,992.98 to the debtor's Form 941 employment taxes (FICA and withholding taxes) for January, 1984;

b. $228,781 to the debtor's Form 941 taxes for February, 1984;

c. $105,765.68 to the debtor's Form 941 taxes for March, 1984;

d. $300,000 to the debtor's Form 941 taxes for April 1984;

e. $229,797.71 to the debtor's Form 720 taxes (excise taxes) for April, 1984;

f. $102,360.01 to the debtor's Form 720 taxes for February, 1984; and

g. $203,000.33 to the debtor's Form 720 taxes for March, 1984. (This sum was misapplied to Form 720 taxes for the 3rd *quarter* of 1984 rather than the 3rd *month* and will be applied correctly with the Court's permission).

3. On June 22, 1984, the Internal Revenue Service received a payment of $200,000 (hereinafter referred to as "Payment 2") which consisted entirely of a $200,000 check drawn from the debtor's IVB checking account no. 0-898-897-8.

4. Pursuant to a designation made by the debtor, Payment 2 was applied in its entirety to the debtor's Form 941 taxes for the 1st quarter of 1984.

5. On June 27, 1987, the Internal Revenue Service received a payment of $11,636.35 (hereinafter referred to as

Payment 3) which consisted entirely of a $11,636.35 check drawn from the debtor's IVB checking account no. 0-898-897-8.

6. Pursuant to a designation made by the debtor, $11,182.87 of Payment 3 was applied to the debtor's Form 940 taxes (FUTA taxes) for 1983 and the remaining $453.48 of Payment 3 was applied to the debtor's Form 11 taxes for July, 1982.

7. The debtor was a monthly filer of Form 941 and Form 720 tax returns beginning no later than April, 1984, and, pursuant to law, was required to make weekly deposits of Form 941 taxes.

8. The debtor was insolvent on 4/30/84, 6/22/84 and 6/27/84.

9. It is stipulated for the purposes of this matter that the requirements of 11 U.S.C. Section 547(b)(5) are met.

Dated: Aug. 6, 1987

Respectfully submitted,

FOR THE TRUSTEE:

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Court Order October 21, 1987